CAPITAL ADEQUACY - PAGE 4

GENERAL

Comments should clearly support the component rating assigned capital, as well as any Examination Conclusions and Comments (ECC) page comments relating to capital. The page heading lists various factors which should be considered in determining the component rating. While these factors may be used as a guide, comments should <u>not</u> necessarily address each factor. Conversely, listed factors are not all-inclusive, and all other relevant issues should be considered. Material conclusions and comments pertaining to capital should be detailed here and summarized on the ECC page. Supplemental capital pages should be included as needed to support core page comments.

Prepare this schedule according to Part 325 of the FDIC Rules and Regulations.

This schedule presents a series of capital ratios based on examination findings. Additional ratios from the UBPR are also included.

CAPITAL RATIOS AND TRENDS

Data for these ratios are as of the current examination and for two prior regulatory examinations. Ratios for prior examinations which are not readily available can be completed as NA (Not Available), or if relevant, may be calculated based on current methodology. Insert additional ratios when necessary.

<u>Leverage and Risk-Based Capital Ratios</u> - Three ratios are included which are based on Part 325 of the FDIC Rules and Regulations (Part 325) rules on Leverage and Risk-Based Capital. Use these ratios in determining compliance with Part 325 minimum capital standards.

<u>Prompt Corrective Action</u> - Two line items are included that relate examination findings to Part 325 Prompt Corrective Action provisions. Include the institution's capital category for Prompt Corrective Action (PCA) purposes based on the capital level <u>after</u> adjustments for examination findings. Address PCA matters on the Compliance with Enforcement Actions page.

Use the ratio, "Tangible Equity Capital/Average Total Assets," for purposes of determining if the institution is "Critically Undercapitalized" for PCA purposes. If the institution does not meet the critically undercapitalized standard and has not previously met this standard, the tangible equity capital ratio does not have to be calculated for either this examination or for prior examinations.

<u>Other Ratios</u> - The ratio, "Total Substandard & Doubtful Items/Total Capital + Ineligible ALLL," is included to assist in determining the level of exposure that adversely classified items pose to the institution's capital and reserve accounts. *Note:* Items classified Loss are not included in the numerator since the Loss has been deducted in the denominator.

Three ratios are included for consideration of the effect on capital of areas other than asset classifications. Include additional ratios if necessary.

When "Institution Only" capital ratios differ <u>significantly</u> from the "consolidated" capital ratios, consider the nature and significance of those differences when evaluating overall capital adequacy and determining the component rating.

INSTITUTIONS IN VIOLATION OF PART 325

Appendix B to Part 325 (Statement of Policy on Capital Adequacy) provides interpretational and definition guidance as to how Part 325 is administered and enforced. Appendix A to Part 325 (Statement of Policy on Risk-Based Capital) sets forth the FDIC's minimum Risk-Based Capital guidelines. Reference these Statements of Policy when necessary.

A state nonmember bank below the minimum leverage requirement (generally 4%) is deemed to be engaging in an "unsafe and unsound practice" that could trigger enforcement action under Section 8 of the FDI Act unless the institution complies with an approved FDIC capital plan. Although a Leverage Capital ratio of at least 4% is not a violation of Part 325, the institution may nonetheless still be engaging in an "unsafe and unsound practice" if the capital level is inadequate given the institution's particular risk profile. An FDIC insured institution with less than a 2% Tier 1 Leverage Capital ratio is considered to be in an "unsafe and unsound condition" that could lead to the termination of deposit insurance under Section 8 of the FDI Act unless the institution complies with an FDIC-approved written agreement for increasing capital. Institutions with a leverage capital ratio of 2% or more may also be operating in an unsafe and unsound condition.

Violations of the Leverage standard should be included on the Violations of Laws and Regulations page and referenced here, as well as on the Examination Conclusions and Comments page.

Failure to meet Risk-Based Capital guidelines is not a violation of law or regulation but is a contravention of an FDIC Statement of Policy. Include details of a failure to meet Risk-Based Capital guidelines on the Violations of Laws and Regulations page under the subheading "Contraventions of FDIC Statements of Policy." Make a reference here and on the Examination Conclusions and Comments page.

APPLICATION TO SAVINGS ASSOCIATIONS

Except in conjunction with the consideration of certain types of applications, Part 325 minimum leverage capital is not a legal requirement directly applying to savings associations for which the FDIC is not the primary regulator. Rather, such savings associations are subject to the minimum Tangible Capital, Core Leverage, and Risk-Based Capital requirements that are included in Part 567 of the OTS Regulations.

When determining capital adequacy, evaluate the savings association using the Leverage Capital analytical standards set forth in Part 325, the extent to which the institution is in compliance with the capital requirements of the OTS, and any related capital plans. Therefore, complete this page in FDIC examinations of savings associations whose primary regulator is the OTS, but only complete sections pertaining to the Leverage Capital amount and ratios. Additionally, make a determination whether the savings association is in compliance with the capital standards in Part 567 of the OTS regulations. Risk-Based data is included for savings associations in the Consolidated Capital Requirement Schedule (Schedule CCR) of the Thrift Financial Report. If the examiner wishes to include ratios for savings associations per Part 567 on the SAER, they should be in the comments section of the SAER and not substituted for the ratios which are based on Part 325.

CAPITAL CALCULATIONS - PAGE 4

GENERAL

Prepare this schedule according to Part 325 of the FDIC Rules and Regulations. The date of the financial information should be the same as the "examination as of date."

For Risk-Based Capital purposes, if Tier 1 Capital is zero or negative, Tier 2 Capital elements will not be recognized when calculating Total Risk-Based Capital. If Total Capital is a negligible or negative amount, but there are capital components that are not being counted due to the Risk-Based Capital rules, additional calculations should be added to show that these capital components exist and are available to absorb losses.

COMPUTATION OF TIER 1 (CORE) CAPITAL

The definition of Tier 1 Capital is the same for both leverage and Risk-Based Capital standards.

Individual captions are provided for Tier 1 Capital Elements, and the amounts included are <u>prior</u> to adjustments to Tier 1 Capital.

Make adjustments to Tier 1 Capital after the line item "Subtotal: Tier 1 Capital Elements." Include appropriate captions when including adjustments. Possible adjustments may include the following items:

- <u>Disallowed Intangibles</u> - Intangible assets are not allowable (except purchased mortgage servicing rights and purchased credit card relationships) for inclusion in core capital pursuant to Section 325.5(f).

- <u>Securities Subsidiaries Subject to Section 337.4</u>

- <u>Assets Other Than Loans & Leases Classified Loss</u> - This item may include Category I contingent liabilities classified Loss. Refer below for further explanation.

- <u>Additional Amount to be Transferred to Tier 2 for Inadequate ALLL</u> - Refer below for explanation.

- <u>Estimated Losses in Contingent Liabilities</u> - This item pertains only to Category II contingent liabilities and might arise from a trust department or from pending litigation.

- <u>Differences in Accounts Which Represent Shortages</u> - This item may include shortages in assets or overages in liability accounts.

- <u>Losses From Apparent Criminal Violations</u> - Material losses attributed to a criminal violation that cannot be addressed by a specific asset classification should be deducted from Tier 1 Capital under the caption "Irregular Transaction -- Estimated Loss." When the exact amount of the loss has not been determined, the examiner may recommend that the institution engage an outside accountant or legal counsel to conduct an appropriate audit or investigation.

Include the above examples <u>only</u> when <u>significant</u>. When appropriate, insignificant adjustments may be addressed in comments on the Capital Adequacy page.

CAPITAL CALCULATIONS - PAGE 4 (continued)

COMPUTATION OF TIER 2 CAPITAL

Tier 2 Capital is used only for Risk-Based Capital standards.

The line item, "Allowance For Loan & Lease Losses," (ALLL) is the ALLL (excluding any Allocated Transfer Risk reserves) as included on the Comparative Statements of Financial Condition page.

Insert the line item, "Loans & Leases Classified Loss," after "Less:" and include the amount of loans adversely classified Loss.

Insert the line item, "Amount Transferred from Tier 1," after "Add:" and include the adjustments necessary to replenish the ALLL to an adequate level.

Eligible ALLL - The eligible amount of the ALL to be included in Tier 2 Capital is limited to 1.25% of gross Risk-Weighted Assets. When the eligible amount is less than the amount shown on the line item "Adjusted Allowance for Loan & Lease Losses," make the appropriate adjustment on the line item "Ineligible Portion of ALLL." Do not include allocated Transfer Risk Reserves (ATRR) and specific reserves created against identified losses in the ALLL nor in Tier 2 capital for this calculation.

Limited-Life Capital Instruments - The outstanding amount of limited-life capital instruments, such as term subordinated debt, are to be discounted for Risk-Based Capital purposes by reducing the outstanding amount by one-fifth of the original amount (less redemptions) each year during the instrument's last five years.

Maximum Tier 2 Capital - The maximum amount of Tier 2 Capital that may be recognized for Risk-Based Capital purposes is limited to 100% of Tier 1 Capital. Deduct any excess amount greater than the limit of 100% of Tier 1 Capital before calculating Tier 2 Capital. Include an explanation after the line item "Other:" and before the line item "Tier 2 Capital."

DEDUCTIONS FROM TIER 1 CAPITAL FOR ITEMS CLASSIFIED LOSS AND INADEQUATE ALLL

Part 325 states that on a case-by-case basis, and in conjunction with supervisory examinations, other deductions from capital may also be required. These should include any adjustments deemed appropriate for identified losses, including assets classified Loss and provisions for an inadequate ALLL.

Use the following method to adjust capital for items classified Loss and to adjust for an inadequate ALLL. This method avoids adjustments that may result in a "double deduction" when Tier 1 Capital already has been effectively reduced through the provision expense in establishing an adequate ALLL. Additionally, this method addresses those situations where certain institutions have overstated the amount of their Tier 1 Capital by failing to take the provision expenses that were necessary to establish and maintain an adequate ALLL.

Method

- Deduct as a separate line item the amount of loss for items other than loans and leases in the calculation of Tier 1 Capital.

- Deduct as a separate line item the amount of loss for loans and leases from the ALLL in the calculation of Tier 2 Capital, and if significant, deduct from Tier 1 Capital the provision expenses necessary to replenish the ALLL to an adequate level.

Evaluation of the adequacy of the ALLL includes consideration of the amount of adversely classified loans and leases. If the ALLL is considered inadequate, make an estimate of the amount of provision needed for an adequate ALLL. Make the estimate after the identified losses in the Report have been deducted from the ALLL. Do not deduct from capital loans and leases classified Doubtful. These will be included in the evaluation of the ALLL, and if appropriate, will be accounted for by the adjustment for an inadequate ALLL.

CAPITAL CALCULATIONS - PAGE 4 (continued)

Method (continued)

Make an adjustment for an inadequate ALLL from Tier 1 Capital to Tier 2 Capital only when the amount is considered significant. The decision as to what is significant is a matter of judgement. As such, consider how much the adjustment would change the Leverage-Capital ratio, how much the reader's perception of the institution's capital level will be influenced, or how much the institution's capital category for Prompt Corrective Action will be changed. Where adjustments for an inadequate ALLL may reduce an institution's capital level to a point where Prompt Corrective Action or other restrictions may apply, particular care and attention including appropriate consultation with the Regional Office should be considered prior to incorporating such adjustments in the examination report.

CAPITAL TREATMENT OF OTHER REAL ESTATE (ORE) RESERVES

ORE reserves, whether considered general reserves or specific reserves, are not recognized as a component of capital for either Risk-Based Capital or Leverage Capital standards. In determining the actual deduction from Tier 1 Capital for "Assets Other Than Loans & Leases Classified Loss," take into account any ORE reserves established as ORE general reserves. To the extent these general reserves adequately cover the risks inherent in the ORE portfolio as a whole, including any individual ORE properties that are assigned Loss classifications, do not deduct the amount of ORE assets classified Loss in determining Tier 1 Capital. When such an adjustment is appropriate, adjust the line item "Assets Other Than Loans & Leases Classified Loss" and footnote with an explanation. However, most ORE reserves, including those established in accordance with AICPA SOP 92-3, are specific reserves rather than general reserves. Net such specific reserves against the amount of the individual ORE property before determining the amount of the classification.

CALCULATION OF TOTAL CAPITAL

Deductions after the line item "Tier 1 Plus Tier 2 Capital" include Investments in Unconsolidated Banking and Finance Subsidiaries. However, these subsidiaries normally are consolidated for Part 325 Capital purposes, except for investments in securities subsidiaries subject to section 337.4, which are already deducted when calculating Tier 1 Capital. Additionally, deduct reciprocal cross-holdings of capital instruments issued by institutions. Other deductions from capital may be required on a case-by-case basis.

RISK-WEIGHTED ASSETS

Calculate Risk-Weighted Assets as of the latest Call Report date. Generally make calculations using Call Report and UBPR data. A supplemental workpaper is available to detail the Risk-Weighted Asset structure, and items in this section are derived from the workpaper.

Risk-Weighted Amounts Deducted from Capital - Deductions include disallowed mortgage servicing rights, goodwill and other disallowed intangibles, Risk-Weighted Assets classified Loss, and any other Risk-Weighted Asset deductions.

CAPITAL CALCULATIONS - PAGE 4 (continued)

AVERAGE TOTAL ASSETS

Average Total Assets are as of the latest Call Report date. Use the amounts deducted from Tier 1 Capital above to adjust "Average Total Assets" and to calculate "Adjusted Average Total Assets." "Adjusted Average Total Assets" is based on the definition of "Total Assets" in Part 325. *Note:* Do <u>not</u> deduct estimated losses in contingent liabilities from total assets.

Reminder: Take Average Total Assets from the latest Call Report date, even if using a month-end financial date throughout the Report.

Hint: Investments in subsidiaries representing majority ownership in another federally-insured depository institution are not consolidated for purposes of completing the Call Reports. However, do consolidate such subsidiaries for purposes of determining FDIC regulatory capital requirements. Therefore, consolidate assets and liabilities of these subsidiaries with those of the parent institution for regulatory capital calculations. However, prepare the Comparative Statements of Financial Condition according to Call Report Instructions. Where such subsidiaries are significant, "Parent Bank Only" financial information and the "Consolidated" information may need to be fully considered.

MEMORANDA ITEMS

<u>Securities appreciation (depreciation)</u> - The first item is the dollar amount of securities appreciation (depreciation) net of Loss classifications reflected in the capital calculations above. The second item is the dollar amount of securities appreciation (depreciation) net of Loss classifications as a percent of Tier 1 Capital.

<u>Contingent Liabilities</u> - The first item, Contingent Liabilities, refers to both Category I and Category II contingent liabilities. The second item, Potential Losses, refers only to Category II contingent liabilities. Refer to the Contingent Liabilities Section of the Manual for a discussion of estimated and potential losses.

References: Part 325 of the FDIC Rules and Regulations
Capital Section of the Manual
Contingent Liabilities Section of the Manual